

Rough First Quarter Reduces 2014 Growth Expectations

We introduced this year's theme—Private Forces Move to the Fore—at the beginning of the year. Our rationale was that reduced uncertainty on the policy and regulatory fronts that had weighed on consumers and businesses in 2013 would set up a foundation for the private sector to strengthen. We also thought the removal of some of the policy support would allow private parties who are undertaking arms-length transactions to determine the real value of assets and liabilities—along the lines of the saying that you don't know who has been swimming naked until the tide goes out. We expected continued improving financial conditions amid the completed household deleveraging process to help support consumers, allowing the economy to accelerate this year.

However, the contraction in economic activity in the first quarter—the first in three years—has diminished the odds that economic growth this year will top last year's pace. While we remain confident that the first quarter decline in growth will reverse and incoming data are showing a pickup in momentum heading into the current quarter, we are skeptical that the strength during the remainder of the year will be enough to overcome the weakness at the start of the year.

Housing has struggled to gain momentum and remains a source of concern. Residential investment fell again in the first quarter of 2014 after a sharp drop in the fourth quarter of 2013. More recent housing indicators are modestly encouraging, suggesting the housing slump is in the past, though the rebound will likely be modest.

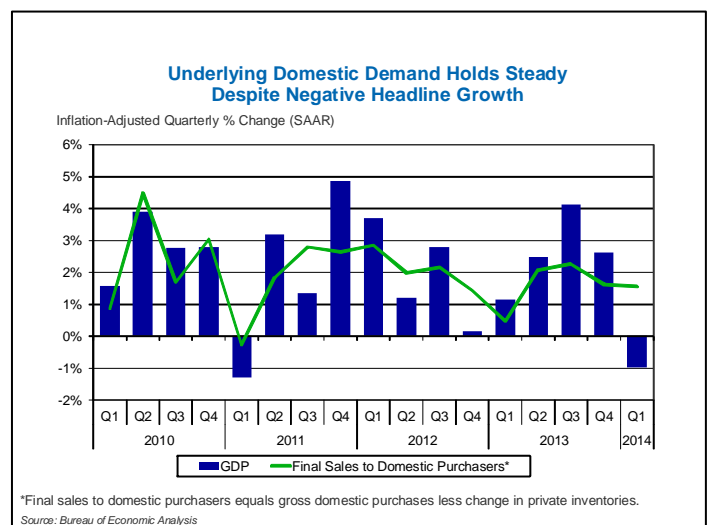
Economic growth should be stronger the second half of this year, averaging approximately 3.0 percent, as our rationale for a positive impulse from the private sector has not changed. We expect growth to come in at 2.1 percent for all of 2014, half a percentage point below the 2013 pace because of the weak start to the year.

Economic Growth: Playing Catch-up

Since the expansion began over four years ago, the first quarter of each year has proved to be the weakest, with the exception of 2012. In its second estimate, the Bureau of Economic Analysis indicates that real (inflation-adjusted) gross domestic product (GDP) fell 1.0 percent annualized in the first quarter of 2014—a downgrade from a 0.1 percent rise in the first estimate. Weaker inventory accumulation than previously reported accounted for nearly all of the downward revision. As a result, the unwinding in inventory investment in the first quarter of 2014 from an undesirable buildup during in the second half of 2013 subtracted 1.6 percentage points from GDP compared to the initially reported 0.6 percentage point drag.

Disruptive weather and a rare drop in real exports also weighed on growth. The view in the rearview mirror continued to soften as the April trade report revised lower net exports in March, suggesting that the decline in real GDP was close to 1.5 percent annualized. However, the data on April net exports were consistent with an acceleration of economic growth in the second quarter.

Real final sales to domestic purchasers—the sum of all domestic purchases excluding the change in private inventories and a more informative measure of the economy's underlying domestic demand—was unchanged at 1.6 percent annualized. The increase in real final sales, albeit steady, was disappointing as it was against our expectations of strengthening private sector demand.



Business capital spending declined in the first quarter for the first time since the third quarter of 2012. Government spending also fell, due to weaknesses in state and local government spending, against our expectation of a rise. As a result, consumer spending, which jumped on the government's assumptions about health care spending related to open enrollment for the Affordable Care Act, was the only contributor to growth. The unusually cold weather increased the energy consumption portion of consumer spending as well.

Monetary Policy: Hike Rate First, Deal with Portfolio Later?

The recent trend in economic activity offers no reason for us to change our expectations regarding monetary policy. We expect the Federal Reserve to stay the course on its pace of tapering asset purchases, ending the program of adding to its portfolio by November of this year, with the first rate hike occurring early in the third quarter of 2015. However, there are a number of subjects on which the Federal Reserve Board will have to make decisions, including whether and/or how to communicate them. For example, a \$4.37 trillion question is when the Fed will cease reinvesting maturing assets to hold the size of its balance sheet constant at the currently high level (estimated to hit a maximum of about \$4.37 trillion, of which \$1.65 trillion will be agency MBS).

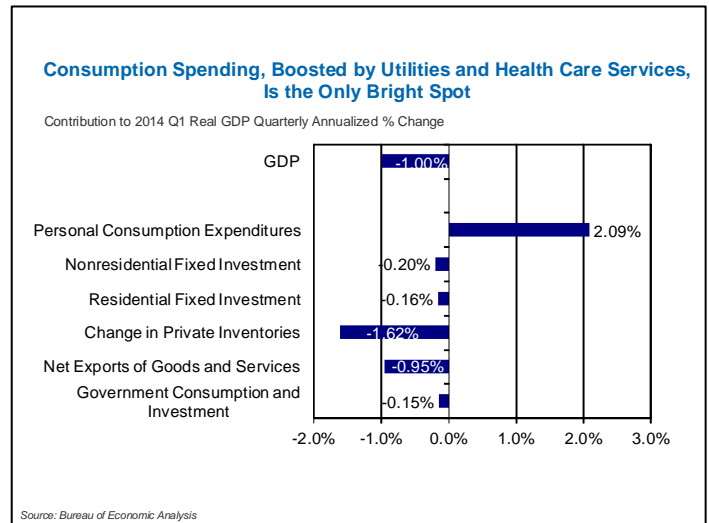
Last month, New York Federal Reserve Bank President Bill Dudley reiterated his view that "ending reinvestments [letting the portfolio run off] prior to lift-off [hiking rates] may not be the best strategy," which is the opposite of the Fed's guidance on exit principles four years ago. Reinvestments of Treasury maturities will be very limited, as the Fed sold nearly all of its short-term securities during Operation Twist. However, reinvestments of MBS securities have been substantial relative to the current pace of originations.

The Fed will have to decide at what pace it allows the portfolio to amortize (specific to the two main types of securities it holds), to what level, whether that level will be constant relative to the overall economy or variable, what the desired duration of the portfolio will be, what the timing of fed funds target changes will be relative to the portfolio decisions, and when and how to move from the traditional fed funds target tool to the reverse repurchase facility as its replacement. How or whether each of these decisions is described to the markets will depend on Fed officials' view of the efficacy of "forward guidance" in achieving their desired policy outcomes.

Consumer Spending: Weakened at the Start of the Second Quarter

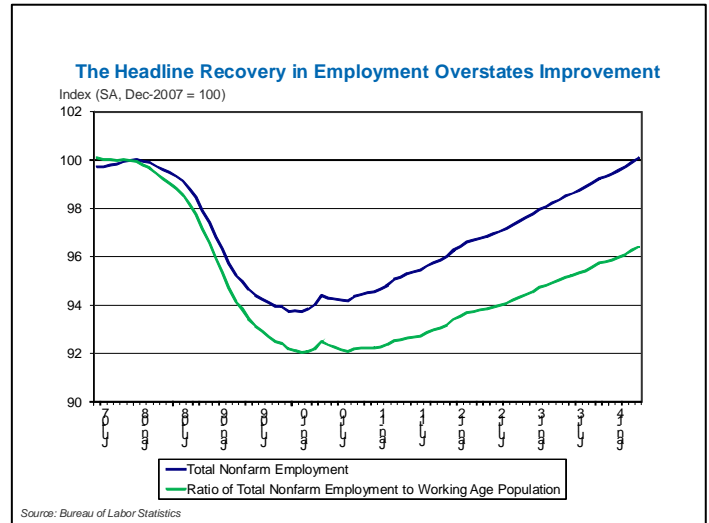
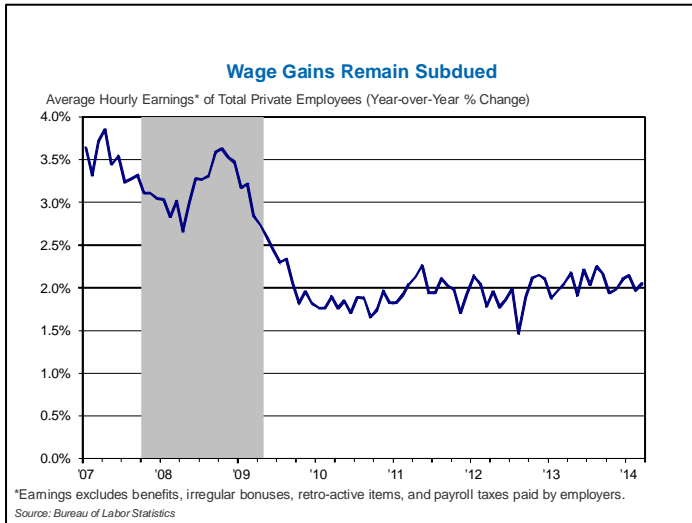
Real consumer spending fell 0.3 percent in April. Weakness was broad-based across all major categories of spending, with a pullback in spending on durable goods leading the way. Spending on both nondurable goods and services also fell. Meanwhile, after strong gains in the prior two months, real income growth moderated in April, rising 0.1 percent, largely due to weaker growth in wages and salaries. Personal income still outpaced spending, pushing the saving rate higher from the recovery low reached in the prior month. The personal consumption expenditure index, the Fed's favored gauge of inflation, rose 0.2 percent from March and 1.6 percent from last April. While the gain was the biggest since October 2012, it remains well within the Fed's target of 2.0 percent.

It appears that consumer spending rebounded in May, presaged by the strength in auto sales, which jumped to the fastest pace in more than seven years. We expect real consumer spending to come in at a slightly stronger pace than in the first quarter, which would mark a recovery-first of three consecutive quarters of more than 3.0 percent annualized growth. Firming labor market conditions and continued rising household net worth should help support consumers going forward.



Labor Market: Steady, but Unspectacular, Gains

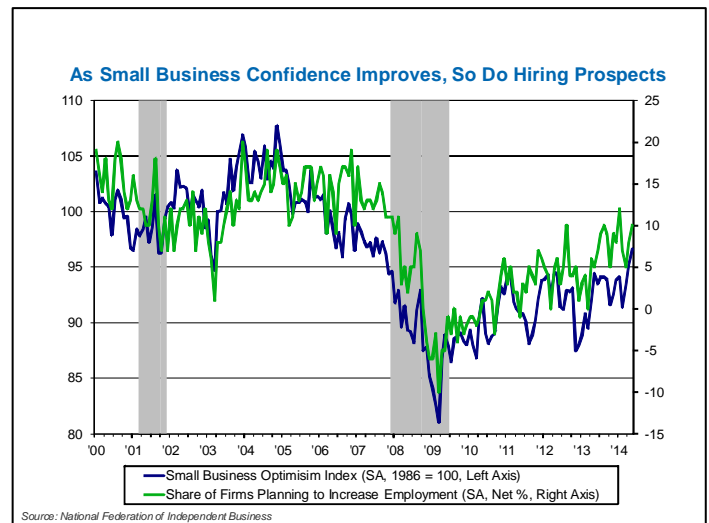
Nonfarm payrolls increased a healthy 217,000 in May on the heels of a modest downward revision in April. The May job gain is in line with the average monthly gain so far this year of 214,000. Other aspects of the jobs market data offered little to cheer about. The average workweek was unchanged at 34.5 hours for the second consecutive month. Following a flat reading in April, average hourly earnings edged up 0.2 percent and were up 2.1 percent from May 2013, little changed from the trend of the past couple of years, which barely keeps up with the pace of inflation and well below the gain witnessed before the recession.



While the unemployment rate held steady at 6.3 percent following a 0.4 percentage point drop in April, the labor force participation rate showed no signs of improvement, remaining at 62.8 percent, which matched its cyclical trough in December 2013—the lowest reading since February 1978.

Nevertheless, the May jobs report offered one landmark: The economy just recovered all of the nearly 9 million jobs lost during the recession. However, since the onset of recession, the working age population (those between 16 and 64 years old) has increased by more than 7 million people. Thus, while total nonfarm payrolls are back to pre-recession levels, the ratio of nonfarm payrolls to the working age population remains 2.5 percentage points below the level at the start of the recession.

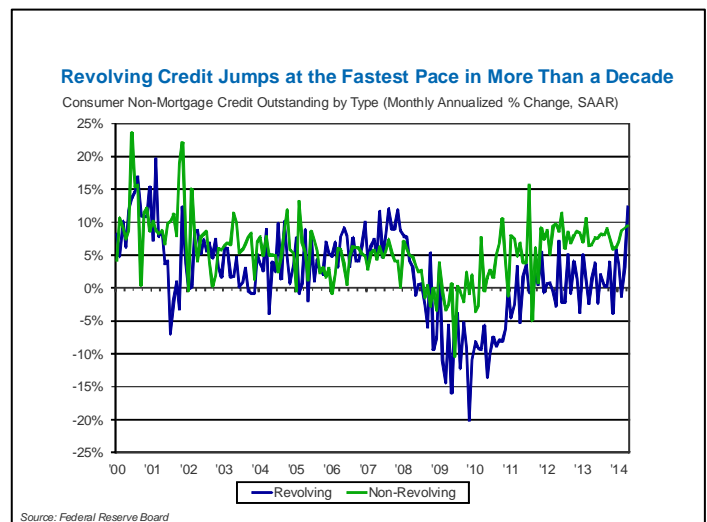
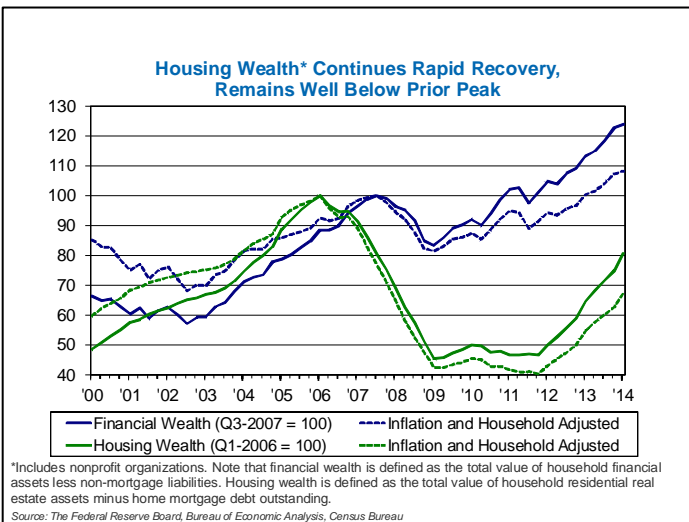
We expect the hiring trend to improve modestly, with monthly job gains averaging approximately 225,000 over the next year, in line with results from the survey of small businesses from the National Federation of Independent Business (NFIB). The May survey showed the optimism index rose for the third consecutive month, sending the index to the highest reading since September 2007, with the net percent of firms planning to hire rising toward its expansion high recorded in January of this year.



Household Net Worth: Ongoing, Uneven, Healing Continues

Another positive factor for consumers is the ongoing improvement in household balance sheets. Data from the Financial Accounts of the U.S. (formerly the Flow of Funds) showed that net worth in the household and nonprofit sector rose \$1.5 trillion in the first quarter of this year to an all-time high of \$81.8 trillion. A gain in assets, including both real estate and financial, drove the increase, while liabilities ticked up only modestly as the increase in consumer credit outweighed the decline in mortgage debt. Though nominal household net worth is now approximately 19.0 percent above the previous peak witnessed in the second quarter of 2007, inflation and household adjusted net worth has risen a much more modest 3.0 percent over that span. In addition, the recovery in household wealth has been uneven among asset types. Financial wealth surpassed its prior inflation and household adjusted peak last year and now sits at an all-time high. Meanwhile, real household adjusted housing wealth, though recovering at a rapid pace since reaching a cyclical low in the fourth quarter of 2011 after declining by more than half, still remains 30.0 percent below the peak reached in the first quarter of 2006.

Monthly consumer credit data showed that consumer credit surged in April, posting the largest increase since July 2011. While non-revolving credit (largely student loans and auto loans) showed a strong increase, continuing its trend over the past three years, revolving credit (largely credit cards) also posted the biggest rise since November 2001.

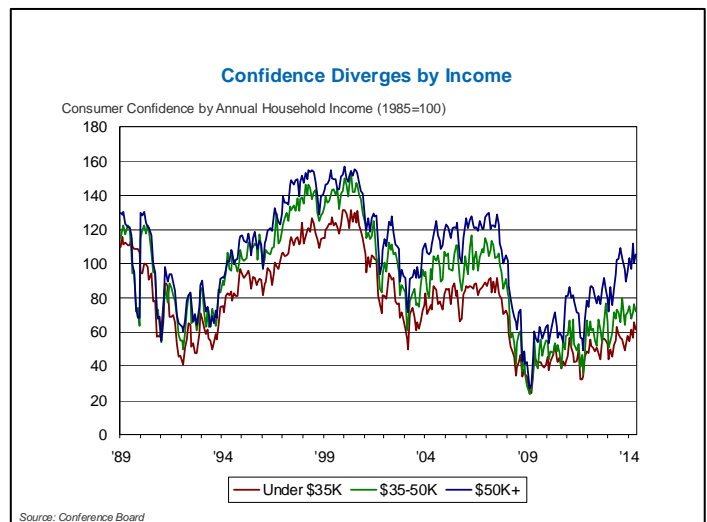


The development in non-revolving credit bears close watching as it has an important implication on consumer spending trends. The latest Fed's Senior Loan Officer Opinion Survey showed that banks continued to increase their willingness to lend to consumers amid easing lending standards, with credit card loans experiencing the largest percent of banks easing standards.

Consumer Confidence: Mixed Signals

The Reuters/University of Michigan survey of consumer sentiment fell in May, pulled down by declines in both the present situation and expectation components, with the former declining to the lowest reading since last November. By contrast, the Conference Board consumer confidence rate rose modestly in May but the details by income showed that confidence increased for only consumers with household income above \$50,000, likely reflecting their improving balance sheet positions.

Results from Fannie Mae's May 2014 National Housing Survey showed that consumers continue to be concerned about the direction of the economy and their household income. The share of respondents who still believe the economy is headed in the wrong direction remained at 57.0



percent last month, and those who said their household income is significantly higher than it was at the same time last year decreased four percentage points to 21.0 percent.

Manufacturing: Gathering Momentum

The industrial production report showed that manufacturing output unexpectedly fell in April after two consecutive solid gains. However, related-factory data suggest that manufacturing output is poised to strengthen in coming months. Durable goods orders rose in April for the third consecutive month. The gain in the headline masks weaker details as core capital goods orders (excluding defense capital goods and aircraft orders)—a leading indicator of business capital spending—fell 1.2 percent. The prior month's gain was revised higher from 2.2 percent to 4.7 percent, continuing to support our view that business capital spending will rebound in the current quarter. Surveys of regional and national purchasing managers point to a favorable trend in the factory sector. For example, the Institute for Survey Management (ISM) manufacturing survey showed that manufacturing activity expanded in May at the fastest pace this year.

Housing Market: the Pullback in Demand May Be Behind Us

Recent housing and economic indicators were mixed, with limited improvement despite the decline in long-term interest rates since the beginning of the year. The yield on 10-year Treasury notes has dropped from around 3.0 percent at the start of the year to slightly more than 2.6 percent at the time of this writing. Meanwhile the yield on 30-year fixed-rate mortgages has fallen approximately 40 basis points.

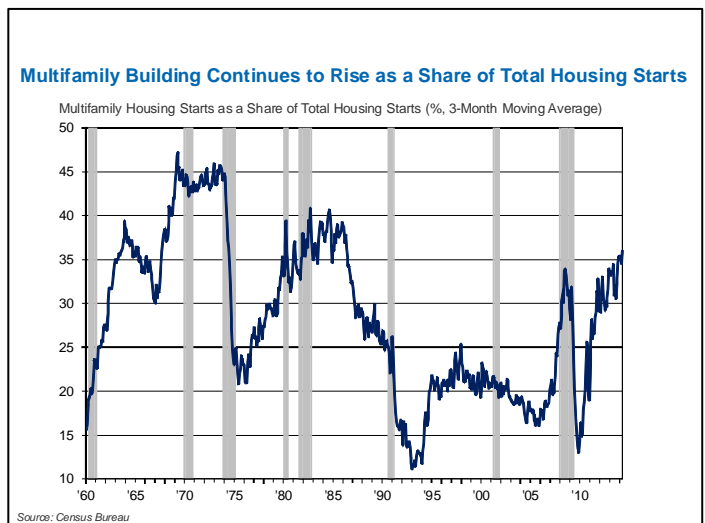
The sudden rate rise initiated in mid-2013 clearly had an impact in dampening housing activity. Prior episodes of rapid rate rise had indicated a likely decline in sales as a response by the housing market. Thus, the setback was not unanticipated although the magnitude of the response was somewhat greater than we anticipated at the start of the year.

After three consecutive monthly drops to start the year, existing home sales were up just slightly in April. The number of homes available for sale (not seasonally adjusted) jumped and was up 6.5 percent from a year ago—the biggest year-over-year rise since late 2010. The months' supply increased to 5.9 months, close to its long-term average and the highest level since August 2012.

New home sales rose for the first time in three months, with the surge in April largely offsetting the large drop in the prior month. Through the first four months of this year, existing and new home sales were 7.0 percent and 3.0 percent, respectively, below those during the same period last year. In addition, near-term leading indicators suggest only gradual improvement ahead. Pending home sales ticked up 0.4 percent in April, and purchase mortgage applications have been trending down since early May.

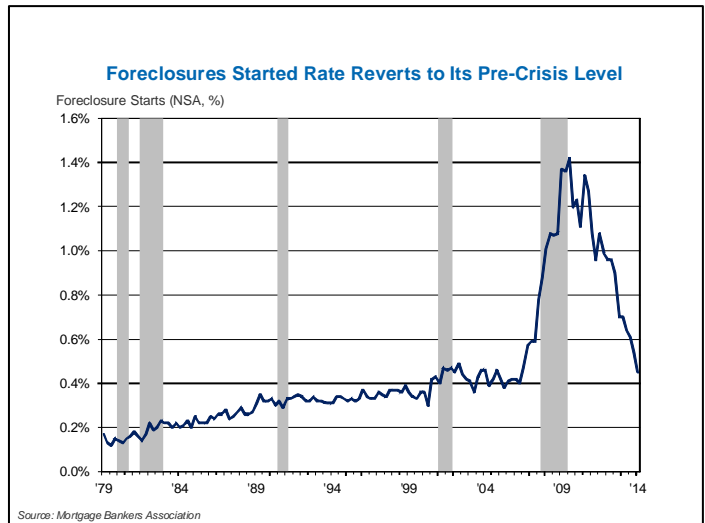
Home builders' confidence edged down again in June, remaining below the 50 mark, which indicates neutral market conditions, for four consecutive months. Confidence has increased only once during the past nine months. Builders' concerns are reflected in single-family home building activity, which showed essentially flat single-family housing starts and builder permits in April. By contrast, both multifamily starts and permits surged during the month. Because of the weak performance of single-family starts relative to multifamily starts in the current recovery, multifamily starts as a share of total housing starts rose to the highest level witnessed since the mid 1980s.

Main measures of home prices continued to show strong gains. For example, the April CoreLogic National House Price Index, which is the measure used by the Fed to estimate real estate value in the Financial Accounts of the U.S., was 10.5 percent above its year-ago level, marking 14 consecutive months of double-digit year-over-year home price gains. Robust home price appreciation has helped homeowners with negative equity regain positive equity in their homes. Data from CoreLogic showed that, at the end of the first quarter of 2014, 6.3 million residential properties, or 12.7 percent of all residential properties with a mortgage, were in a negative equity position, compared with 9.8 million properties (a 20.2 percent share) a year ago.



Strong home price trends also have helped to facilitate sales of distressed properties and expedite the pace of resolution of nonperforming loans. According to the Mortgage Bankers Association National Delinquency Survey for the first quarter of 2014, the seriously delinquent rate, which includes loans that are 90 days or more past due or in the foreclosure process and serves as a proxy for shadow inventory, declined for the tenth consecutive quarter to 5.0 percent—approximately 4.6 percentage points below its peak reached more than four years ago. In addition, the rate of new foreclosures started, which captures the flow of loans that enter the foreclosure process, fell to 0.45 percent. This marks the lowest reading since the second quarter of 2006 and matches its long-term average.

Mortgage rates have stabilized over the past month with the yield on 30-year fixed-rate mortgages moving within a narrow range of 4.10 to 4.20 percent. We expect rates to rise modestly, ending the year below 4.5 percent as indicated by the forward yield curve. Our projected housing activity is little changed from our view in the prior month. We expect this year's total home sales to decline slightly from 2013—the first retreat in four years. Home price gains should moderate as the number of homes available for sale in the existing home market increases throughout the year amid modestly rising new construction. For all of 2014, total mortgage originations should decline to \$1.13 trillion from an estimated \$1.91 trillion in 2013, with the refinance share dropping from an estimated 62.0 percent in 2013 to 37.0 percent in 2014. For mortgage debt, the latest data from the Fed showed that total single-family (1-4 unit properties) mortgage debt outstanding fell 1.4 percent annualized in the first quarter of this year. We expect it to post a slight gain for all of 2014, marking the first annual rise in seven years.



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